United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7141

United States Court of Appeals

For the Second Circuit

INDEPENDENT INVESTOR PROTECTIVE LEAGUE, *et al.*,

Plaintiffs,

against

AVCO CORPORATION, *et al.*,

Defendants.

EDDIE L. THOMPSON, JR.,

Plaintiff-Appellant,

against

ARTHUR YOUNG & COMPANY,

Defendant-Appellee.

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEE ARTHUR YOUNG & COMPANY

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Statement of the Issues

Does the claim of an investor that a company's financial statements were "misleading" raise a triable issue of fact against the company's outside auditors, where the matters as to which the investor claims he was "misled"

were fully disclosed in the financial statements in the manner prescribed by applicable accounting regulations of the SEC, and where the investor asserts no facts other than those contained in the financial statements to support his claim?

The District Court answered this question in the negative and awarded summary judgment in favor of the auditors.

Statement of the Case

Plaintiff-appellant Eddie L. Thompson, Jr.* brought this action to recover losses he allegedly sustained in purchasing shares of Cartridge Television, Inc. in the two years between that company's July 13, 1971 public offering and its filing of a Chapter XI petition on July 6, 1973. (Complaint ¶¶2 *et seq.*; A 31 *et seq.*).** The lengthy complaint included

* This case was brought as a class action, but no motion for class certification was made. Papers recently filed below on behalf of plaintiff Thompson express a desire not to proceed on a class basis provided certain other persons are allowed to intervene as plaintiffs. (Notice of Motion and Affirmation of I. Walton Bader dated April 5, 1975). This matter is presently pending before the court below. Mr. Thompson's original co-plaintiff, the Independent Investor Protective League, withdrew from this case following a decision by Judge Cooper in another suit that the League lacks standing to bring such actions: *Independent Investor Protective League* v. *American Export Industries, Inc.*, 73 Civ. 3612 (SDNY Sept. 11, 1972). See Report and Recommendation of Magistrate Gerard L. Goettel, Dec. 16, 1974.

** References preceded by an "A" are to plaintiff-appellant's appendix on this appeal; references with the prefix "SA" are to the supplemental appendix of defendant-appellee Arthur Young & Company. Although the complaint speaks of a May 19, 1971 Prospectus, this reference is erroneous as the final Prospectus pursuant to which Cartridge's public offering was made was dated July 13, 1971. This Prospectus is reproduced in Arthur Young's Appendix at SA 7.

among its lengthy roster of defendants Arthur Young & Company, Cartridge's outside auditors. The claim against Arthur Young was contained in one "count" under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j, which alleged "misleading financial information" in Cartridge's July 13, 1971 Prospectus and in its Annual Reports for the years 1971 and 1972. (Complaint ¶45; A 49). Specifically, plaintiff charged that, in the financial statements, "the financial picture of the operations of Cartridge Television, Inc. is completely distorted by the carrying of current expenses (referred to as 'research and preoperating costs') as 'deferred expenses'." (Complaint ¶46, A 49-50).*

The complaint's allegations against Arthur Young were baseless on their face because the very financial statements upon which plaintiff sued

1) disclosed how the sums captioned "research and preoperating costs" had been spent;

2) disclosed that Cartridge as a company in the "development stage" was deferring these costs (including depreciation that was charged) to be amortized over a period to begin after sales of the company's products commenced, and

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* This paragraph, which contains the complaint's *sole* substantive allegations against Arthur Young, reads in its entirety as follows:

> "FORTY-SIXTH. In the said financial statements, the financial picture of the operations of CARTRIDGE TELEVISION, INC. is completely distorted by the carrying of current expenses (referred to as 'research and preoperating costs') as 'deferred expenses.' Thus the poor financial picture of CARTRIDGE TELEVISION, INC. (which caused it to file a Petition in Bankruptcy in June, 1973) was completely masked in the financial information submitted. Furthermore the said Defendants did not charge depreciation with respect to the production facilities and equipment of CARTRIDGE TELEVISION, INC., further masking the true financial position of said Corporation." (A 49-50).

3) further disclosed that recovery of the deferred costs was dependent upon future operations and therefore could not be assured.*

Arthur Young accordingly moved for summary judgment dismissing the complaint, pointing out not only that the nature of the deferred costs had been fully disclosed, but also that these matters had been presented in precisely the manner prescribed by Article 5A of the SEC's Regulation S-X, 17 C.F.R. §210.5a, which spells out a special format for the financial statements of development-stage companies such as Cartridge. The District Court granted Arthur Young's motion, holding that

> "It is clear beyond factual or legal question that this firm of accountants did its work responsibly, lawfully and conformably to SEC regulations, misleading neither the plaintif nor anyone else in any actionable or realistic sense, and revealing plainly the very facts which plaintiff finds in the questioned documents and then describes as having been 'completely masked'." (A 17)

Since the court below granted summary judgment in Arthur Young's favor, it did not reach that branch of Arthur Young's motion which sought security for costs and expenses, including reasonable attorneys' fees. (A 15) While confident that the award of summary judgment will be sustained, Arthur Young has filed a cross-appeal (SA 1) to put before this Court its belief that this suit is

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* See discussion at pp. 6-12, *infra*. Plaintiff-appellant's appendix herein includes only one page of Cartridge's financial statements, taken from the statements included in the company's 1972 Annual Report: A 61. For the Court's convenience, Arthur Young has reproduced in its supplemental appendix the entire Prospectus of July 13, 1971, as well as portions of the 1971 and 1972 Annual Reports, in each case containing the full quartet of financial statements which appeared therein: SA 27-32; SA 36-39; SA 44-48.

"A. They were disclosed. My knowledge of how

one in which security for costs and expenses is necessary to protect Arthur Young from the utter recklessness, tantamount to bad faith, which has marked plaintiff-appellant's conduct of this groundless suit from its outset.

I

No triable issue of fact exists as to the propriety of Cartridge's financial statements.

As set forth *infra*, Cartridge at the time of its July 13, 1971 Prospectus and subsequent annual reports was a company in the "development stage" under applicable SEC accounting regulations; the deferral of its research and preoperating expenses and the presentation by Cartridge of these matters in its financial statements was in accordance with those regulations. After being confronted with Arthur Young's demonstration of these realities, plaintiff below promptly conceded, as he does here, that SEC accounting regulations do indeed provide for the deferral of such expenses by development stage companies. (A 20; Appellant's Brief p. 5). There is, accordingly, no dispute between the parties on this point. Nor is there any dispute as to the accuracy of the information contained in Cartridge's financial statements. On the contrary, plaintiff assumes the accuracy of that information; this case thus presents the paradox of a plaintiff whose claim that financial statements were misleading is based on the disclosures made in those same documents.

Plaintiff does assert, based on nothing other than the amount of money Cartridge's Prospectus disclosed it had spent, that the company was engaged in "unsuccessful experimentation" and therefore was not in the "development

stage." This contention—correctly termed by the court below a "locution without business or legal significance" (A 18), does not raise an issue of fact which would require or even be capable of resolution by a trial of this action. Plaintiff's alternative contention, that Cartridge's financial statements were "misleading" notwithstanding that they were prepared in the format specified by the SEC's accounting regulations, is incorrect as a matter of law and fails for the further reason that plaintiff has pointed to nothing "misleading" in the financial statements which was not plainly disclosed by them. The court below was thus eminently correct in its conclusion that no factual dispute existed here which would preclude summary judgment in Arthur Young's favor.

A. The deferral of Cartridge's research and pre-operating costs was reported in its financial statements in the manner provided for by applicable accounting regulations of the SEC.

Cartridge was a company organized to develop, manufacture and market a new product, specifically, a video color tape cartridge system for home use. As explained in the Prospectus on its July 13, 1971 public offering, the company had been in existence for only three years and had had no operating revenues since its inception; prototype units of its "Cartrivision" system had been exhibited publicly but it was not expected that production would be sufficiently advanced to permit sales to consumers before mid-1972. (Prospectus pp. 2-3, 6-7; SA 8-9, 12-13). From an accounting standpoint, therefore, Cartridge was a classic example of a company "in the development stage":

> "A company in the development stage will be directing its efforts to establishing a business and laying a foun-

> dation for the generation of future earnings. To that end it will ordinarily be devoting substantially all of its efforts to (or have under consideration) such start-up activity as research, development of a product of service, exploration for and development of natural resources, financial planning, property acquisition, marketing studies, personal recruitment and raising capital. Also, significant preoperating costs will usually have been incurred or (can reasonably by expected) relating to financing and the day-to-day administrative function. In particular, the description 'company in the development stage' is intended to include a company that has completed its initial financing (seed money), even though it has not commenced its other planned development stage activities. Generally, a company in the development stage will not have had significant revenues from its proposed endeavors.''*

The SEC requires companies in the "development or promotional stage" which for the past five years have "not had any substantial gross returns from the sale of products or services, or any substantial net income from any source" to use Form S-2 (rather than the Form S-1 used by operating companies) when registering shares for sale to the public pursuant to the Securities Act of 1933: 17 CFR Pt. 239, No. S-2; 38 F.R. 17205. Similarly, Article 5A of the SEC's Regulation S-X, 17 CFR §210.5a, prescribes a special format for companies in the "development or promotional stage" to use for presentation of their financial information in filings under the 1933 Act as well as under the Securities Exchange Act of 1934. This specialized format "deals with the uncertainty of cost recoverability and the inability to

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* This statement, reproduced at SA 53-54 and SA 73, appears in AICPA, Committee on Companies in the Development Stage, Preliminary Draft of *Audits of Companies in the Development Stage* (July 1973), p. 3, quoted in FASB Discussion Memorandum, *Accounting for Research and Development and Similar Costs* (Dec. 28, 1973), p. 54.

objectively value the non-cash consideration received for capital shares'' of development-stage companies, FASB Discussion Memorandum, *Accounting for Research and Development and Similar Costs* (Dec. 28, 1973), p. 57; SA 57.

Since Cartridge was a company ''in the development stage'', the financial information included in its July 13, 1971 Prospectus and subsequently in its 1971 and 1972 Annual Reports was presented in the format specified by Article 5A of Regulation S-X as appropriate for such companies. Thus, instead of a balance sheet and income statement presenting financial position and results of operations, Cartridge's financial information consisted of the four separate statements prescribed by Article 5A of the SEC's Regulation S-X:

(1) a statement of assets and unrecovered development costs, captioned the Statement of Assets, Intangibles and Deferrals;

(2) a Statement of Liabilities;

(3) a Statement of Capital Shares; and

(4) a Statement of Cash Receipts and Disbursements. (See Prospectus pp. 22-24; SA 28-29). Article 5A statements do not purport to show financial position and results of operations, and consequently Arthur Young rendered its opinion as to whether the Cartridge statements presented the matters set forth therein in accordance with the accounting requirements of the SEC.

The first of the financial statements included in Cartridge's July 13, 1971 Prospectus was the ''Statement of

Assets, Intangibles and Deferrals (Notes 1 and 3)'' at March 31, 1971. That Statement reported Current Assets totalling $75,966; ''Property, plant and equipment at cost'' less accumulated depreciation of $184,186 for a total of $2,189,596, and the item ''Intangibles and Deferrals'' under which appeared ''Research and preoperating costs (Note 1)'' of $6,075,700. What those ''research and preoperating costs'' represented—how that money had been spent—was itemized in detail in the accompanying Statement of Cash Receipts and Disbursements. Note 1 to the financial statements, captioned ''Basis of Financial Statements; research and preoperating costs'' then stated as follows:

> ''The Company is in the development stage. Its personnel are currently involved in the process of planning for the production and marketing of its recorder-playback units and cartridges and design and engineering of certain additional products related to the CARTRIVISION system; accordingly, all its costs, which include $184,186 of depreciation, are being deferred. The Company estimates that approximately $24,474,817 (including $8,325,817 incurred through March 31, 1971) are required to develop its products and production techniques and to acquire property, plant and production equipment. The Company has no commitments or arrangements for financing its forecasted expenditures beyond July 14, 1971, other than the public offering of securities contemplated by this Prospectus. While management believes these costs will be fully recovered, the ultimate recovery of costs incurred or to be incurred is dependent upon future developments, including achievement of a level of operations which would permit such recovery. The eventual outcome of these matters cannot be determined at this time.
>
> ''The Company intends to continue deferring all costs incurred until sales of its products commence.

> The Company plans to amortize research and preoperational costs applicable to each product by charges to earnings based on units expected to be sold, subject to increased amortization if sales exceed projections, during the 36 months beginning with the first sales of the respective products."

Arthur Young's report on the financial statements of Cartridge included in the July 13, 1971 Prospectus repeated the disclosure made in Note 1:

> "As discussed in Note 1, the Company has incurred significant amounts of research and preoperating costs, which costs have been deferred. It is not possible at present to determine whether these costs ultimately will be recovered since recovery is dependent on the success of future operations."

Arthur Young then expressed its opinion as follows:

> "In our opinion, the statements mentioned above present fairly, on the basis of the applicable accounting requirements of the Securities and Exchange Commission, which constitutes an acceptable basis for presenting the accounts of the Company at this time, the historical cost of assets, intangibles and deferrals, the historical liabilities and the historical capital shares of Cartridge Television, Inc. at March 31, 1971 and its cash transactions for the period June 27, 1971, on a consistent basis throughout the period." (SA 27).

The financial statements included in Cartridge's 1971 and 1972 Annual Reports were in the same form as those in the Prospectus, and the same disclosures were made in the notes to the statements and in Arthur Young's reports thereon. See 1971 Annual Report pp. 9-12; SA 36-39, and 1972 Annual Report pp. 4-8; SA 44-48).

That Cartridge's financial statements, prepared in accordance with applicable SEC standards, effected disclosure fully as complete as that thought desirable by advanced professional opinion at the time those statements were reported upon by Arthur Young can be seen by comparing the Notes numbered 1 in Cartridge's financial statements included in the July 13, 1971 Prospectus and in the 1971 and 1972 Annual Reports, summarized above, with the Note 1 proposed in 1973 by the AICPA's Committee on Companies in the Development Stage for a hypothetical Acme Motorcycle Company:

> "Note 1.—Basis of Financial Statements and Accounting Policies
>
> "The accompanying financial statements give recognition to the facts that the Company is in the development stage and has no operating history. Except for costs associated with an abandoned project, all costs incurred, reduced by revenues, have been accumulated because they were incurred in the expectation they would benefit future periods. It is not practicable, at the present stage of the Company's activities, to determine the extent of recoverability of the accumulated research, development or preoperating costs or of the costs incurred for property, plant equipment or patents. Recoverability is dependent upon future events, including the ability of the Company to raise any needed capital, to attain the goals of its development program, to market its products successfully and to achieve a satisfactory level of operations. The outcome of these matters cannot be determined at this time."* (SA 67).

* The model statements, reproduced at SA 64-69, appear in AICPA, Committee on Companies in the Development Stage, Preliminary Draft of *Audits of Companies in the Development Stage*, pp. 47-52 (July 1973), quoted in FASB Discussion Memorandum, *Accounting for Research and Development and Similar Costs* (Dec. 28, 1973) at pp. 105-109.

Like the model Note 1 recommended by the AICPA Committee, Cartridge's financial statements disclosed the facts that the company was in the "development stage"; that all of its costs were accordingly being deferred to be amortized against future revenues; that recovery of such costs was dependent on future events, primarily the company's ability to achieve a necessary level of operations and to obtain needed financing, and that "the outcome of these matters cannot be determined at this time." Cartridge's financial statements and the reports of Arthur Young thereon disclosed these matters in virtually the identical way that an AICPA committee two years later would recommend as the standard to be adopted throughout the profession, and in any event told the investor everything he needed to know.*

B. Plaintiff does not raise a triable issue of fact by proffering the unsupported assertion that Cartridge had spent too much money to be in the development stage.

Not in his complaint, nor in answering interrogatories where he was asked to particularize his claim, nor in pretrial testimony, but only after Arthur Young's motion for

* On July 19, 1974, the Financial Accounting Standards Board issued a "Proposed Statement of Financial Auditing Standards", or exposure draft (SA 85), recommending (contrary to the views of the AICPA committee which the FASB superseded) that the use of Article 5A statements be abandoned; that development stage companies in the future report their financial information by means of a conventional balance sheet and income statement, and that such companies charge to expense as incurred those of their preoperating costs which an operating company would so charge rather than deferring them as has heretofore been the practice. FASB, Proposed Statement of Financial Accounting Standards: *Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components* (July 19, 1974). The FASB exposure draft has not been adopted as an accounting standard, and even if adopted does not represent a standard applicable to Cartridge in 1971 and 1972, when the SEC's Article 5A set that standard: *Spiegler* v. *Wills,* 60 FRD 681 (SDNY 1973); *Shahmoon* v. *General Development Corp.,* 1973-74 CCH Fed. Sec. L. Rep. Transfer Binder ¶94,308, p. 95,039 (SDNY Dec. 1, 1973).

summary judgment, did plaintiff in a transparent effort to create an issue which would keep his case alive come up with the idea that Cartridge had spent too much money to have been in the "development stage". To this end, plaintiff proffered the affidavit of one George Abramson, identified as the President of a company "engaged in the appraisal, promotion and development of patents and inventions" (A 25), which stated as follows:

> "I have read the prospectus of CARTRIDGE TELEVISION, INC., which claims that this company is a company in the developmental stage.
>
> In my opinion, on the date of the prospectus, CARTRIDGE TELEVISION, INC. was not a company in the developmental stage by reason of the fact that the prospectus indicates that at least $7,509,000 of additional preoperating costs would have to be incurred before the item involved would be salable. The total amount expended, at that time, for preoperating costs was $6,076,000.
>
> Based upon these figures it is my opinion that the company was involved in a mere abandoned experiment and the costs originally incurred would not be properly deferrable." (A 25-26).

An "opinion" to the same effect was offered from one Lowell M. Reed (whom plaintiff identified on deposition as his personal accountant in Spartanburg, South Carolina, EBT 190; SA 120):

> "A company, in my opinion, which has spent, approximately, $6,000,000 and estimates an expenditure of $7,000,000 before any units could be sold, is not a company in the developmental stage.
>
> The so-called 'Research and preoperating costs' actually constitute 'unsuccessful experimentation' and,

therefore, the deferral of the expenditures was improper." (A 21).

The "opinions" of Messrs. Abramson and Reed are by their own avowal founded on no facts whatever beyond the Prospectus' disclosure that Cartridge had spent $6,075,000 and expected to spend an additional $7,500,000 in developing its product. Neither affidavit offers a scintilla of accounting, legal or other authority to support the commonsense defying proposition they advance, and plaintiff's counsel on oral argument below candidly stated that he knew of none.* The authorities, of course, go in the opposite direction. Under the SEC's Regulation S-X as under the AICPA and FASB treatments of the subject (of which Messrs. Abramson and Reed pointedly say nothing), whether a company is in the "development or promotional stage" for financial reporting purposes does *not* depend on the amount of money it has spent (that being a function of whether it is developing widgets or nuclear power plants), but rather on whether it is engaged in the activities characteristic of companies developing a product and on whether it has begun to conduct operations and receive revenue therefrom. There is no doubt but that Cartridge met these tests at the time of the financial statements in question.**

* In response to questions asked by Judge Frankel on oral argument, counsel stated:

"MR. BADER: Oh, in other words, what you are asking me, your Honor, is do I know of any authority in the accounting profession that says this.

THE COURT: Or in the legal profession.

MR. BADER: Or in the legal profession?

THE COURT: I even look at legal authorities.

MR. BADER: And if I may say to your Honor, the answer is 'No'." (Transcript p. 24; SA 98).

** As disclosed in its 1972 Annual Report (SA 42), Cartridge did begin to make sales of its product during that year. The notes

Nor does plaintiff challenge in any way the Prospectus' description of the activities Cartridge was engaged in—developing a product, building plants to manufacture it, raising capital and the like, all of which conform perfectly to the accountants' description of the activities which characterize a "development stage" company. In these circumstances, plaintiff does not raise an issue of fact which would require a trial merely by positing that a company spending $13.5 million in developing, manufacturing and bringing to market a technologically complex new product must *ipso facto* be engaged in "unsuccessful experimentation."

II

Cartridge's financial statements could not, as a matter of law, have misled the reasonable investor.

Plaintiff urges on this appeal that, even if Cartridge's financial statements followed Article 5A of the SEC's Regulation S-X to the letter (as of course they did), they could

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to the financial statements for the year ending November 30, 1972 accordingly stated that for the fiscal year beginning December 1, 1973 the company would be regarded for financial reporting purposes as an operating company, and amortization of its deferred costs would begin as set forth in the note. (SA 46). In its 1973 quarterly statements Cartridge did indeed report on an operating company basis.

In response to a question asked by Judge Frankel prior to oral argument below, plaintiff's counsel attempted to urge (without citation of authority) that the fact that Cartridge had made some sales in 1972 meant that its financial statements for that year should not have been presented in the development-company format. Accounting authorities, however, recognize that the transition from a development to an operating company is not made overnight at the time of the first sale, but rather depends on several factors; it is logical and in no way improper for such a company to change the basis of its accounting at the beginning of its new fiscal year rather than mid-stream. See the AICPA report at pp. 4-5; SA 54-55.

still be "misleading" under Rule 10(b)(5). Arthur Young believes plaintiff to be in error in this regard as a matter of law, but it is scarcely necessary to reach the question to dispose of this appeal, because plaintiff has been unable to advance even the shadow of a reason for supposing that the financial statements of Cartridge could have misled anyone who took the trouble to read them.

A. What plaintiff claims was "misleading" was plainly disclosed.

Manifestly the assertion by Mr. Thompson that he was "misled" by Cartridge's financial statements does not create an issue of fact which would require a trial of this action. The law presumes a reasonable investor reasonably familiar with business practices, *U.S.* v. *Koenig*, 388 F. Supp. 670, 700 (SDNY 1974), and the question is therefore whether a reasonable investor reading those statements could have been misled by them.

In an affidavit below plaintiff Thompson attempted to specify the manner in which he was "misled" by Cartridge's financial statements as follows:

> "In the prospectus on page 22 there is what purports to be a 'Balance Sheet'. The part of the statements, which I believe to cover 'Assets', is called 'Statement of Assets, Intangibles and Deferrals.' I assumed that 'Intangibles and Deferrals' were a species of 'Asset' and not, in effect, expenses which were not charged."

There is, however, nothing in Cartridge's financial statements which is captioned or which "purports to be a 'Bal-

ance Sheet' ". Instead, there are the four separate statements specified by Article 5A of the SEC's Regulation S-X: a Statement of Assets, Intangibles and Deferrals, a Statement of Liabilities, a Statement of Shareholder's Equity, and a Statement of Cash Receipts and Disbursements. The obvious reason for the SEC's requirement that a development-stage company present a statement captioned "Assets, Intangibles and Deferrals" instead of a plain statement of "Assets" is to put the reader on notice that the items being reported are likely to include substantial unrecovered or deferred charges in addition to such assets as cash and plant, property and equipment.

To insure that the reader would not miss the point, Cartridge's Statement of Assets, Intangibles and Deferrals expressly referred the reader—at two places—to Note 1 to the financial statements, where (as in Arthur Young's report thereon) it was clearly explained that Cartridge had incurred these substantial research and preoperating costs in developing its product; that since the company was in the development stage, all of its costs were being deferred to be amortized over a period to begin after sales of its product commenced, and that there could be no assurance that these costs could or would ultimately be recovered. In addition, in the separate Statement of Cash Receipts and Disbursements, the research and preoperating costs were itemized in fourteen categories, so that the reader was informed as to how these monies had been spent. (SA 29) When Mr. Thompson says that Cartridge's financial statements concealed from him the fact that the deferred costs were "in effect, expenses which were not charged", he demonstrates nothing but his own failure to

read the statements in the first place and, perhaps, his own lack of comprehension of the nature of a deferred charge.*

On his examination before trial in this case, Mr. Thompson stated that he brought this suit against Arthur Young based on "the misleading information that was pointed out to me in the prospectus and the company annuals" by his counsel, Mr. Bader. (EBT 288; SA 127). Mr. Thompson candidly admitted that the matters which he claims were "misleading" had indeed been disclosed in the Cartridge Prospectus:

> "Had I known of this Note 1 of the $6,075,000 was carried in there as an asset, had I been smart enough to realize that these deferrals of operating cost was carried as an asset, I would not have made the purchase. That was misleading to me at this stage." (EBT 360; SA 144)

And again:

> "Q. Was the fact that the research and preoperating costs were being deferred disclosed in the notes to the financial statements?

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* If Mr. Thompson means by this statement that these costs were expenses which were not recorded on Cartridge's books, he is of course in error; they were charged, and the basis on which this was done is fully disclosed in the financial statements.

If Mr. Thompson means to say he was misled by the fact that the deferred costs did not appear on an income statement as charges against income in the current year, he fails to grasp that the Cartridge financial statements did not include an income statement but rather, on the Article 5A format, reported the company's expenses in the Statement of Cash Receipts and Disbursements as money spent.

Mr. Thompson also suggests that he would not have been "misled" had the deferred costs been reported in Cartridge Statement of Liabilities instead of on the Statement of Assets, Intangibles and Deferrals. (A 28-29; Appellant's Brief p. 2). The difficulty here, of course, is that the deferred costs were not an obligation of Cartridge—since the money had been spent and was not owed—and did not represent a liability of that company

"A. They were disclosed. My knowledge of how they were carried was not clearly understood." (EBT 367; SA 145)

Similarly, Mr. Thompson did not read either the notes to the financial statements contained in the 1971 Annual Report or the report of Arthur Young thereon:

"Q. Did you read the notes to the financial statements in that annual report?

"A. I do not recall of having read the notes of 1971. I had already made investments in the company. I was still buying the stock under recommendations and from figures I had here, I thought the company had that amount of money. As an unsophisticated investor, I don't think I can read every item that's detailed. If the stock is so recommended to you and you have the same faith on that person that you had the confidence in, most anyone would omit some of the readings of the financial statement of such." (EBT 407-08; SA 149-50)

As the court stated in *Shahmoon* v. *General Development Corporation,* 1973-74 CCH Fed. Sec. L. Transfer Binder ¶94,308, p. 95,039 (SDNY Dec. 1, 1973):

"There can be no recovery for a 10b-5 violation unless there was a misrepresentation. Considering the fullness of information in the statements in question (with its detailed footnotes which Shahmoon did not read), which give a fair presentation of defendant's operation, the omission [of a certain matter of accounting practice] cannot be considered a material misrepresentation within the meaning of Rule 10b-5."

The key to the securities laws is disclosure, and the plain fact is that Cartridge's financial statements disclosed exactly the basis on which they were prepared, so clearly

that plaintiff's counsel now purports, by looking at nothing but the statements themselves, to be able to say how they were "misleading". Such a self-proving fraud is no fraud at all. As Judge Pollack said in *Spiegler* v. *Wills*, 60 FRD 681, 683 (SDNY 1973):

> "* * * [T]he naked assertion of concealment of material facts which is contradicted by published documents which expressly set forth the very facts allegedly concealed is insufficient to constitute actionable fraud."

Similarly, the court in an analogous situation in *Colonial Realty Corp.* v. *Brunswick Corp.*, 337 F. Supp. 546, 552 (SDNY 1971) held:

> "Any claim by plaintiff of deceit through the use of the accrual method borders on the incredible in view of the clear statement in the prospectus that 'profits on instalment sales are taken into income in the period in which the sales are recorded.'"

All of the care which the accounting profession requires, which the securities laws exact and which Arthur Young took in this case for the protection of the investor are of no avail if the investor does not read the disclosures made to him with sufficient attention to absorb their substance. Plaintiff's claim here that the deferral of Cartridge's research and preoperating expenses was "misleading" transcends the incredible in view of the clear disclosure, in each of the financial statements in question, as to what the expenses were, the basis on which they were being deferred, the basis upon which they would ultimately be amortized, and the fact that their recovery could not be assured. There is no basis for a claim of deceit here.

B. Arthur Young can have no liability for Cartridge's presentation of financial information in the form required by the SEC.

This case is unusual in that plaintiff complains, not that information was misrepresented or omitted from financial statements, but rather that the *form* in which information was presented was misleading: plaintiff Thompson says that the fact that Cartridge's deferred costs appeared on a "Statement of Assets, Intangibles and Deferrals" caused him not to realize that these costs were really "expenses which were not charged." (A 28) However, Article 5A of Regulation S-X specifies that a company reporting its financial information thereunder shall include its unrecovered promotional, exploratory and development costs on a statement of assets and unrecovered (i.e. deferred) costs. The right and indeed the only place for Cartridge to report its deferred research and preoperating costs was, therefore, in its Statement of Assets, Intangibles and Deferrals, and plaintiff does not suggest that Article 5A would have permitted any other presentation of this item. Plaintiff is, then, attempting in this suit to hold Arthur Young liable for fraud by reason of Cartridge's compliance with the accounting requirements of the SEC.

Section 19(a) of the Securities Act of 1933, 15 U.S.C. §77s(a), which authorizes the SEC to promulgate the accounting requirements embodied in Regulation S-X, also makes good-faith compliance with those requirements an absolute defense to liability under the statute:

> "No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the

> Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial authority to be invalid for any reason."

It is submitted that, since Cartridge's financial statements followed the format specified by the SEC regulations, Arthur Young is entitled to the protection afforded by this section. *Cf. Colonial Realty Corp.* v. *Brunswick Corp.*, 337 F. Supp. 546, 551 (SDNY 1971).

In his instant brief plaintiff cites *U.S.* v. *Simon*, 425 F.2d 796 (2d Cir. 1969) and *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (SDNY 1974), for the proposition that an accountant does not necessarily satisfy the requirements of full disclosure by complying with generally accepted accounting principles. (Appellant's Brief p. 6). Assuming *arguendo* the validity of this proposition, plaintiff's reliance on it is misplaced in the context of this case, because there is no claim here, as there was in those cases, that the financial statements in question failed to disclose material adverse information known to the accountants. On the contrary, there *was* full disclosure in the present case—so full that plaintiff points to no information beyond that contained in the financial statements themselves in support of his contention that the manner in which that information was presented was "misleading." Plaintiff also relies on §23 of the Securities Act of 1933, 15 U.S.C. 77w, to establish that filing of a registration statement is not a finding by the Commission that such statement is free from misstatements and omissions. (Appellant's Brief p. 6) However, plaintiff in this suit does not allege that Cartridge's financial statements contained any untrue statement or omission which the Commission's

examination during the registration process might not have uncovered. The instant complaint is directed, rather, to the form in which the information was presented, and that form was actually prescribed by the SEC. Manifestly this is the situation with which §19(a) was designed to deal, and it should be given effect here.

C. The "questions" raised by the Reed affidavit are make-weight and nothing more.

The affidavit of Mr. Thompson's Spartanburg accountant Mr. Reed (to whom Mr. Thompson showed the Cartridge financial statement for the first time after this suit was brought, EBT 191; SA 121) says, with respect to "the financial statements where the so-called 'Research and preoperating costs' are itemized", that "there are two items which I question." (A 22) Plaintiff is not entitled to keep this case alive for the purpose of obtaining answers to Mr. Reed's "questions", for "The office of a fraud complaint is to seek redress for a wrong, not to find one." *Lewis* v. *Varnes,* 368 F. Supp. 45, 47 (SDNY), aff'd 505 F.2d 785 (2d Cir. 1974); *accord, Segal* v. *Gordon,* 467 F.2d 602, 607-08 (2d Cir. 1972). Nor, as is apparent from looking at Cartridge's financial statements, has Mr. Reed by raising his "questions" raised any genuine issue of material fact which would require a trial of this action:

(1) An item appears in Cartridge's Statement of Cash Receipts and Disbursements in the Prospectus captioned "Avco's production start-up costs" of $393,779 (SA 29), which Mr. Reed says is "without any itemization as to what this figure consists of * * *." (A 22)* Mr. Reed simi-

* Note 3(b) to the financial statements ("Transactions with Avco Corporation"), as well as the Prospectus at page 8, explains the role Avco was to take in manufacturing Cartridge's product. SA 31; SA 14.

larly notes that the statements contained, under the subheading "Research and preoperating costs", a sub-subitem for "other" expenses ($208,590) which were not further itemized. These "other" research and preoperating costs were less than 5% of Cartridge's disbursements as reported in the financial statements which appeared in the Prospectus, and approximately 10% of those reported in the 1971 and 1972 Annual Reports. (SA 29, 37, 45) These matters were not material, *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (SDNY 1969), and Mr. Reed offers no authority to suggest that further "itemization" of these matters was required or that its absence could have misled anyone.

(2) Mr. Reed's affidavit says (apparently referring to the Prospectus' Statement of Cash Receipts and Disbursements, SA 29), that "there is a figure of $1,593,483 listed as 'accrual adjustments' without any specification as to what the figure involves." (A 22) What the accrual adjustments represent, however, is perfectly clear. Cartridge recorded its disbursements on the accrual basis —as the statement's heading "Disbursements (accrual basis)" indicates—so that, to present a statement of *cash* disbursements (required by Article 5A of the SEC's Regulation S-X), it was necessary to subtract from Total Disbursements (Accrual Basis), as shown on the statement, the accrued but not paid items ("Accrual adjustments") to arrive at "Total Cash Disbursements". There is nothing "questionable"—much less misleading—about this computation, which is performed for all to see on the face of the Statement of Cash Receipts and Disbursements itself.

(3) Finally, Mr. Reed though agreeing that it was permissible for Cartridge to defer for financial statement

purposes expenses which had been claimed as federal income tax deductions in the current year, says that "* * * some note of how much was included as a deduction for income taxes should be included in a note of explanation to avoid misunderstanding." (A 22) Curiously, and strongly suggesting that Mr. Reed along with plaintiff and his counsel has never really read Cartridge's financial statements, the *exact amount* of these deductions is in fact disclosed in Note 5 to the financial statements included in the Prospectus.*

III

Plaintiff has failed to demonstrate a basis for having asserted claims against Arthur Young & Company. If this suit were to continue, plaintiff should be required to post security for Arthur Young's costs, which under the securities laws include attorneys' fees.

As a new company Cartridge was a highly speculative investment, and its Prospectus was plastered with warnings to this effect. (See the "Risk Factors" enumerated at pp. 2-4, SA 8-10). Plaintiff Thompson bought Cartridge stock, so he says, because his broker told him the company

* Note 5 reads:

"Research and preoperating costs which the Company has deferred for financial statement purposes (Note 1) are claimed as deductions for federal income tax purposes in the year incurred. As a result, the Company has an operating tax loss carryforward of approximately $690,000 relating to the year ended November 30, 1969, which expires in 1974. Research and preoperating costs of approximately $3,640,000 for the year ended November 30, 1970 and $1,746,000 for the four months ended March 31, 1971 also will be deducted for tax purposes, resulting in operating tax loss carryforwards which expire in 1975 and 1976, respectively. The Company's tax returns have not been examined by the Internal Revenue Service." (SA 26).

would be "another Xerox." He paid $20 per share for the Cartridge stock he bought pursuant to the public offering, and he made additional purchases as the price rose subsequently until, on January 21, 1972, he sold out his position at $34 for a profit in excess of $60,000. (EBT 35, 36, 39-40, 50-50a; SA 100, 101, 102-03, 104-05). A week later, with the stock at $40, Mr. Thompson says his broker told him he had made a mistake to sell; based on nothing but his broker's recommendation he made substantial additional purchases. (EBT 54-57; SA 106-09). From that time until its bankruptcy in July, 1973, the price of Cartridge shares declined steadily, but Mr. Thompson kept buying the stock. He bought, for example, in May, 1973 after Cartridge announced major plant cutbacks (EBT 162-164); he bought after hearing the company planned to petition in bankruptcy, and he even bought months after bankruptcy —"a little bit of crapshooting," as he testified. (EBT 169; SA 116).

Now, seeking indemnity for his losses, Mr. Thompson has sued everyone connected with Cartridge including its outside auditors, Arthur Young. He sues on Cartridge's prospectus, but he made a substantial profit on the Cartridge shares he purchased thereunder. He claims Cartridge's financial statements were "misleading," but he never read them with care and was impervious to the disclosures they made. His claim, as articulated by his attorney who invented it, is so garbled as to be incomprehensible, and is devoid of factual allegations of *scienter,* intent to defraud or reckless disregard for truth required in this Circuit to support a suit under Rule 10(b)(5): *Lanza* v. *Drexel, Inc.,* 479 F.2d 1277 (2d Cir. 1973); *Shemtob* v.

Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971).* Without such factual allegations, and in the absence of reliance, causation, or even damage, Mr. Thompson and his counsel have sought to subject Arthur Young to the costly and time-consuming defense of a major securities action involving every aspect of Cartridge's business and affairs.

Even a layman, such as Mr. Thompson, ought to be aware that a suit against a public accountant for fraud does serious damage to that accountant's reputation for professional integrity, which is his lifeblood. *Segal* v. *Gordon*, 467 F.2d 602 (2d Cir. 1972); *Sloan* v. *Canadian Javelin, Ltd.*, 1973-74 CCH Fed. Sec. L. Rep ¶94,579 (SDNY May 30, 1974). Even a layman, such as Mr. Thompson, ought to appreciate the gravity of such a charge when, as he admits, he did not read the financial statements which his suit says were deceptive. Mr. Thompson's counsel ought also to appreciate the seriousness of his utterly irresponsible and baseless charge in this matter. If the present suit is

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* The count of the complaint in this action which is directed to Arthur Young purports to be brought under "* * * the Securities Acts of the United States and, in particular, without limiting the generality of the allegations Sections 10(b), 13, 18, 20 and 27 of the Securities Exchange Act of 1934 * * *," (Complaint ¶45; A 49). Arthur Young has always assumed this to be a §10(b) case, although plaintiff's testimony on deposition that he did not even read, much less rely upon, Arthur Young's report or the notes to the financial statements included in the 1971 and 1972 Annual Reports would appear to doom his prospects for recovery under that section as well as under §18, 15 U.S.C. §78r: *Titan Group, Inc.* v. *Faggen*, CCH Fed. Sec. L. Rep. Current Transfer Binder ¶95,042 (2d Cir. April 1, 1975). In his present brief plaintiff appears to invoke §11 of the Securities Act of 1933, 15 U.S.C. §77k, with respect to the Prospectus on Cartridge's July 13, 1971 public offering. It suffices to say that plaintiff could not maintain a §11 claim because he, in fact, made a $60,000 profit on the Cartridge shares he bought on the public offering pursuant to the Prospectus, and because his claim—since it is allegedly discoverable simply by reading the financial statements—was not brought within one year of the time when discovery could have been made with reasonable diligence as required by §13, 15 U.S.C. §77m.

allowed to proceed, Arthur Young should be secured by an undertaking for the expenses, including reasonable attorneys' fees, to which it will thereby be subjected. Ample authority for such relief exists in §18 of the Securities Exchange Act of 1934, 15 U.S.C. §78r and in §11 of the Securities Act of 1933, 15 U.S.C. §77k, whose intent was to protect defendants against "strike suits" or "litigations brought in bad faith," S. Rep. No. 792, 73rd Cong., 2d Sess. (1934) at 17-18; *Klein* v. *Adams & Peck,* 436 F.2d 337 (2d Cir. 1971); *Leighton* v. *Paramount Pictures Corp.,* 340 F.2d 859 (2d Cir.), *cert. denied,* 381 U.S. 925 (1965); *Linchuck* v. *Cooper,* 43 FRD 382 (SDNY 1967); *Dabney* v. *Alleghany Corp.,* 164 F.Supp. 28 (SDNY 1958).

Conclusion

The order of the District Court granting summary judgment in favor of Arthur Young & Company should be affirmed. If this action is allowed to proceed on any basis against Arthur Young, this Court should condition such further proceedings upon an undertaking from plaintiff for Arthur Young's costs and expenses including attorneys' fees.

Dated: New York, New York
May 12, 1975

Respectfully submitted,

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